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THESIS

THE INTERNAL CONTROL SYSTEM AND CONTROL
PROGRAMS: A REFERENCE GUIDE

by

Debra A. Lewandowski

June 1990

Thesis Advisor:

Glenn Eberling

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The Internal Control System and Control Programs:
A Reference Guide

by

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Lieutenant, United States Navy
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Submitted in partial fulfillment of the
requirements for the degree of

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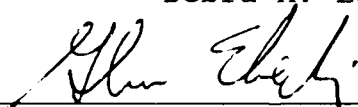
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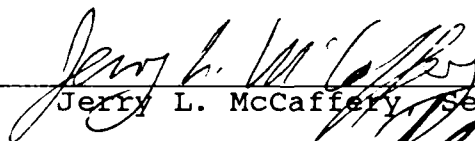


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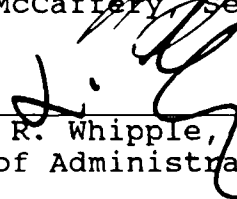
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ABSTRACT

This thesis was designed as a reference guide for managers, specifically Commanding Officers and Comptrollers, concerning the internal control system and control programs. It provides a general overview of the internal control system and discusses the various external and internal audits, inspections, reviews and investigative organizations and programs. The thesis defines the audit system and includes audit standards and the audit process. Practical guidelines for preparing for and participating in audits or inspections are included. An additional reading list of relevant directives and instructions governing the various programs and agencies is intended as a central resource for managers to obtain additional information.



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I. INTRODUCTION

A. DISCUSSION

Taxpayers are becoming increasingly concerned with how the government spends its money, particularly in defense-related areas. With constant discussions concerning the spiraling budget deficit and resultant interest payments, the media and taxpayers are demanding closer scrutiny of the budget and how government funds are spent.

Congress attempts to control wasteful spending through budget restraints. For instance, audit reports generally recommend various savings and benefits. Theoretically, if the recommendations are enacted by the auditee, budget savings should accrue. However, if these recommendations are not implemented, Congress can restrict the budget to the amount of the projected savings under the assumption that an efficiently managed program would require less funding.

The Accounting and Auditing Act of 1950 required internal control systems and placed the responsibility for developing them on agency heads. The Federal Manager's Financial Integrity Act of 1982 required, among others, standard controls. These two acts created various programs. Specifically in the Navy, auditors were assigned to verify compliance with the controls, the Internal Review Program was developed to help Commanding Officers assess their commands'

compliance with controls, and finally, the Management Control Program placed responsibility on functional managers to assure adequate controls exist in their organizations.

Although these programs still exist, a changing perspective has developed. Auditors rely less on compliance audits and spend more of their time assessing the effectiveness and efficiency of certain programs in terms of monetary benefits. Compliance has not been deleted as a prime concern, only given less priority.

Currently, the Naval Postgraduate School teaches the Practical Comptrollership Course and Financial Management in the Armed Forces Course, using the same text for both. The present chapter on auditing provides a detailed background on the history of audits and controls as well as the organizations involved. It does not offer a practical approach for preparing and participating in the audit.

Recent policy changes throughout the audit, review and control programs need to be incorporated into the chapter. For example, the Naval Audit Service, within the past couple of years, changed its audit emphasis from the short, compliance audits of activities to the longer, more complex program audits. A second example involves the very recent cancellation of the Internal Review Program by the Secretary of the Navy.

B. PURPOSE OF RESEARCH

The primary purpose of this thesis was to develop a practical reference guide for managers, specifically Commanding Officers and Comptrollers, concerning the internal control system and control programs. This guide will be incorporated into the text used in the Practical Comptrollership Course and Financial Management in the Armed Forces Course at the Naval Postgraduate School.

C. SCOPE OF RESEARCH

This thesis reviews:

- current control, audit, and review policies.
- standards for internal controls, audits and the audit process.
- information regarding the various audit, investigation and review organizations which affect the Navy.
- guidelines for preparing and participating in an audit.
- rights for the audited organization.

Since the purpose of the thesis is to develop a desktop reference guide, a synopsis was used, providing necessary information for the understanding of the programs and standards. Instructions and directives provide full details and discussions for each.

D. RESEARCH APPROACH

Research for this thesis covered two areas: an exhaustive review of pertinent directives and instructions, and interviewing various managers. Interviews with program

headquarters' staff facilitated a better understanding and clarity of the written directives. Interviews with field managers provided experienced advice for participating in audits, reviews and inspections.

Due to the variety of agencies and programs examined in this thesis, no standard questionnaire was developed. Information gathered through the interview process was the result of free-form commentary, personal and phone interviews from members of various comptroller departments, at all levels; commanding officers; former internal review staff members; and field auditors of the Naval Audit Service, as well as headquarters staff of the various audit, review and inspection agencies. Interviews lasted between 45 and 90 minutes.

Interviewees included the following commands and agencies:

- Office of Inspector General, Department of Defense.
- Office of Inspector General, Department of the Navy.
- Naval Military Personnel Command.
- Naval Supply Systems Command Headquarters.
- Navy Accounting and Finance Center, Washington, D.C.
- Naval Audit Service, Washington, D.C.
- Commander in Chief, U.S. Pacific Fleet (CINCPACFLT), Pearl Harbor.
- Naval Air Force, U.S. Pacific Fleet (AIRPAC), San Diego.
- Naval Surface Force, U.S. Pacific Fleet (SURFPAC).
- Naval Postgraduate School, Monterey.

- Naval Air Station, Alameda.
- Naval Air Station, Whidbey Island.
- Naval Air Station, Lemoore.
- Naval Sub Base, Bangor.
- Defense Investigative Service, Monterey.
- Naval Investigative Service, Resident Agency, Monterey.

E. THESIS ORGANIZATION

The thesis is organized as follows: Chapter I provides the methodology and scope of the thesis. Chapter II gives a general overview of the internal control system and discusses the various external and internal audits, inspections, reviews and investigative organizations and programs. Chapter III defines the audit system, and includes audit standards and the audit process. Chapter IV provides practical guidelines for preparing for and participating in audits or inspections.

Finally, an additional readings list is attached as an appendix. This detailed list of the directives and instructions governing the various programs and agencies is intended as a central resource for managers to obtain additional information relevant to each chapter.

II. INTERNAL CONTROL SYSTEM

This chapter introduces the topics of management control and auditing in the Navy, including various external and internal audit organizations and programs, Inspector General (IG) inspections, internal review organizations as well as the Management Control Program.

A. REASONS FOR MAINTAINING A CONTROL SYSTEM

An entity's management is responsible for establishing an internal control structure to assure compliance with laws and regulations. The lack of administrative continuity in government units because of continuing changes in elected legislative bodies and in administrative organizations increases the need for an effective internal control system. [Ref. 1:p. 4-2]

In an era of decreasing resources due to budget deficits and competing requirements, federal government financial managers should actively promote economy, effectiveness and efficiency when expending financial resources. This entails strong management controls. To provide "maximum benefit with minimum effort (efficiency)" [Ref. 2:p. 20] without considering the cost implications (economy) or ability to achieve one's mission (effectiveness) does a disservice to the federal government and management's role in preserving the integrity of the financial affairs of the government. [Ref. 2:p. 20]

With increasing oversight from the media, Congress and the public, failure to use financial resources economically, efficiently and effectively could result in funds recoupment by higher authority.

Through the reports generated by the various audit and control agencies, Congress attempts to promote greater economy, effectiveness, and efficiency by controlling and restraining those areas of the budget which are identified in the reports as areas of concern and weakness. Managers must take strong action to correct these areas or face budget sanctions. For example, in 1985,

...the House Committee on Armed Services has become aware of the Navy inaction in improving its internal audit function and, to emphasize its concern, deleted \$100 million from the Navy Fiscal Year 1988 (FY88) Operation and Maintenance budget request. The Government Accounting Office (GAO) concluded the congressional message is that an effective Navy audit organization would have identified at least \$100 million in potential monetary benefits from its recommendations. [Ref. 3:p. 64]

The periodic rotation of managers provides opportunities for inefficiency or fraud since managers typically are concerned with short-term goals at the expense of long-term results. With a good control system, managers have set performance standards with which to judge organizational effectiveness, allowing weaknesses to be detected and corrected. Problem areas not internally detected may be detected through other control systems such as external audits or inspections.

As a control measure, audits and inspections keep managers informed of areas of strength, weakness or possible misrepresentation by employees. Audits and inspections serve as an instrument with which to recognize outstanding performance, and as a deterrence against fraud, waste and abuse. The potential for fraud, waste or abuse is diminished if the staff expects an independent third-party review and verification of their respective actions.

A good internal control and review system helps management recognize deficiencies thus allowing an opportunity for immediate identification of problem areas and required corrective action. It also helps to identify potential repeat audit findings.

A well-run organization should welcome audits and reviews for two reasons. Problem areas identified in an audit can be corrected, developing a more efficient and effective organization; and those organizations with no problems can be recognized as such due to the lack of audit findings. [Ref. 4]

B. THE INTERNAL CONTROL STRUCTURE

Auditing textbooks define the internal control structure to "include the control environment, the accounting system and the control procedures." [Ref. 5:p. 274] According to the Comptroller General, "good internal controls are essential to achieving the proper conduct of Government business with full

accountability for the resources made available." [Ref. 6:p. 1]

The control environment reflects the overall philosophy of top management. [Ref. 5:p. 274] Department of Defense (DOD) philosophy states

Internal controls are management's responsibility and should be in effect across the board in every organization within each DOD component. Adequate internal control is required to assure that all resources are efficiently and effectively managed and is the basic foundation for integrity in any management system. Although internal controls in themselves cannot prevent every incident of waste, mismanagement, and fraud, DoD policy is to ensure that resources are properly managed and controlled within the Department of Defense. [Ref. 7:p. 1]

The accounting system pertains to the control over the entity's transactions and the related assets. [Ref. 5:p. 274]

The Accounting and Auditing Act of 1950 requires agency heads to establish and maintain effective systems of internal control. The objectives require that:

- a. Obligations and costs comply with applicable law
- b. Assets are safeguarded against waste, loss, unauthorized use, and misappropriation
- c. Revenues and expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared and accountability of the assets may be maintained. [Ref. 6:Introduction]

Although the objectives of internal controls seem to indicate that financial programs are the only programs which are of concern, this is not the intent. Internal controls apply to all programs, administrative and operational. [Ref. 8:p. 9]

Control procedures allow management to meet these objectives. [Ref. 6:p. 1] The control procedures established in an organization reflect the minimum level of quality performance required. [Ref. 6:p. 2] An effective control system can diminish, but not necessarily eliminate, the opportunity for collusion or fraud.

C. TYPES OF CONTROLS

Government controls are classified as either general, specific or audit resolution standards. These controls were developed by the Comptroller General as a requirement of the Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512(b)). Office of Management and Budget (OMB) Circular No. A-123 revised, dated August 16, 1983 has a full discussion of the standards.

1. General Standards

a. Reasonable Assurance. Internal control systems are to provide reasonable assurance that the objectives of the systems will be accomplished. The benefits derived should exceed the cost of the internal control system. The benefits should reduce the risk of failing to achieve the control objectives.

b. Supportive Attitude. Managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times.

c. Competent Personnel. Managers and employees are to have personal and professional integrity. They are to maintain a level of competence that allows them to accomplish their assigned duties, as well as understand the importance of developing and implementing good internal controls.

d. Control Objectives. Internal control objectives are to be identified or developed for each agency activity and are to be logical, applicable, and reasonably complete.

e. Control Techniques. Internal control techniques are to be effective and efficient in accomplishing their internal control objectives. Control techniques promote consistent performance.

2. Specific Standards

a. Documentation. Internal control systems and all transactions and other significant events are to be clearly documented, and the documentation is to be readily available for examination.

b. Recording of Transactions and Events. Transactions and other significant events are to be promptly recorded and properly classified.

c. Execution of Transactions and Events. Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority. Authorizations are to be made in writing.

d. Separation of Duties. Key duties and responsibilities in authorizing, processing, recording, and reviewing transactions should be assigned to separate individuals to minimize the risk of loss to the government.

Internal control depends largely on the reduced opportunities to make and conceal errors or to engage in or conceal irregularities. This, in turn depends on the assignment of work so that no one individual controls all phases of an activity or transaction, thereby creating a situation that permits errors or irregularities to go undetected.

e. Supervision. Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved, and approved procedures are followed.

Lines of personal responsibility and accountability are to be clearly established.

f. Access to and Accountability for Resources. Access to resources and records is to be limited to authorized individuals, and accountability for the custody and use of resources is to be assigned and maintained. Periodic comparison shall be made of the resources with the recorded accountability to determine whether the two agree. The

frequency of the comparison shall be a function of the vulnerability of the asset.

3. Audit Resolution Standard

a. Prompt Resolution of Audit Findings. Managers are to (1) promptly evaluate findings and recommendations reported by auditors, (2) determine proper actions in response to audit findings and recommendations, and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention. [Ref. 9:p. 6-8]

D. INTERNAL CONTROL SYSTEMS

The major systems of internal control for the Department of the Navy include formal audits, economy and efficiency reviews (formerly, internal review) and the Management Control Program. These management tools help ensure the integrity of the system and complement each other. Controls form the basis from which audits and reviews are performed.

The chief differences between the programs reflect the level of independence provided to the command being inspected, audited or reviewed.

Audits are the formal program which management can use to evaluate its control system. Audits differ from management control reviews and economy and efficiency reviews in that they are performed by qualified professional auditors following GAO Audit standards. These auditors are independent from the influence of the function being audited. Audit results are made available to those interested, including Congress, and other auditing and inspection agencies.

Economy and efficiency reviews lie strictly within the confines of the command for the Commanding Officer's sole use as an internal assessment of the control system. Personnel assigned to the command conduct the reviews. The findings are confidential and not released outside the command; thus, the Commanding Officer has the incentive to investigate and correct problem areas promptly.

The Management Control Program is a review performed by the managers themselves to determine whether their functional area has adequate internal controls based on levels of vulnerability and risk. Review results are incorporated into the command's consolidated report. The Commanding Officer determines which areas are reported to the next level in the chain of command. Each echelon level command merges the reports until they are consolidated at the DOD level into a joint service report that is presented to Congress and the President.

E. EXTERNAL AUDIT, INVESTIGATIVE AND INSPECTION ORGANIZATIONS

Since reports from external (to the DON) organizations sometimes recommend areas where economic savings could accrue, any concurrence could affect future budget plans. If managers do not agree with the findings, they should justify their rationale for not concurring. For example, a manager could request additional sampling if the original sample was not an accurate portrayal of events.

1. Congressionally Controlled Oversight Organizations

The Government Accounting Office (GAO) is responsible for making independent evaluations of agencies and functions of the Executive Branch of the government....GAO reports generally contain findings, conclusions and recommendations that identify problems, highlight areas where management could be improved, and offer potential corrective actions. The reports have a substantial impact on Congressional and public views concerning DON activities. [Ref. 10:p. 1]

The Surveys and Investigations Staff of the House Appropriations Committee reviews Navy programs for Congress. Since the reviews are not conducted by professional auditors, they are not bound by the strict GAO Standards or audit objectives. Thus, their conclusions and recommendations may not be statistically accurate.

2. Military Oversight Organizations

The following major operational audit and inspection organizations are designed to meet DOD policy

...to provide adequate audit coverage of all DoD organizations, programs, activities, and functions as an integral part of the DOD management system. The objectives of auditing are to conduct independent evaluations of DOD programs and operations, and to determine whether internal control systems are adequate; information is reliable; applicable laws, regulations and policies are followed; resources are safeguarded and managed economically and efficiently; and desired program results are achieved. [Ref. 11:p. 1-2]

a. Inspector General

(1) DOD Inspector General (DODIG).

The Inspector General is required to...conduct, supervise, monitor, and initiate audits and investigations relating to programs and operations of the DOD; provide leadership and coordination and recommend policies for activities designed to promote economy, efficiency, and effectiveness in the administration of, and to prevent and detect fraud and abuse in, such programs and operations; provide a means for

keeping the Secretary of Defense and the Congress fully and currently informed about problems and deficiencies relating to the administration of such programs and operations and the necessity for and progress of corrective action. [Ref. 12:p. 1-2]

The major thrust of IG inspections centers on mission economy and effectiveness, and reviewing special interest items. These inspections differ from audits in that they are not performed by professional auditors nor are auditing standards followed. They are very limited in duration, generally lasting a few weeks versus months or years.

Special interest items are the result of Congressional interest and/or common, recurring discrepancies found during inspections. The major high interest items for FY90 are DOD Environmental Program; Health Care; Defense Management Report; Manpower and force structure; product substitution, defective pricing and poor accounting systems. IG teams routinely investigate hotline tips. [Ref. 13]

DOD IG is a civilian appointed by the President with the consent of the Senate. [Ref. 12:p. 1-2]

(2) Department of the Navy (DON) Inspector General (NAVINSGEN).

As the principle advisor on all inspection and noncriminal investigation matters it is intended that NAVINSGEN act as the "eyes and ears" of SECNAV, CNO and CMC in all integrity and efficiency matters. The term "inspection" encompasses not only command inspections, but the efforts of any group or person within the DON who evaluates units and activities. This term encompasses all examinations and inquiries into any matter in which DON has interest which are not included in NAVINSGEN's annual integrity and efficiency plan. [Ref. 14:p. 2]

These inspections concentrate on compliance and operational issues. NAVINSGEN is a military component of the Office of the Secretary of the Navy. The IG teams are normally comprised of a permanent cadre of military and DON civilian personnel, occasionally supplemented with subject area experts from the field.

Major/sub claimant IG teams operate under the NAVINSGEN instruction. All reports are sent to NAVINSGEN.

OPNAVINST 5040 lists the NAVINSGEN special interest items. Appendix A lists common discrepancies found during command inspections.

b. Defense Contract Audit Agency

The Defense Contract Audit Agency provides contract audit services as well as accounting and financial advisory services to all DOD activities responsible for procurement and contract administration. [Ref. 15:p. 1] The director, a civilian selected by the Secretary of Defense, receives agency direction and authorization from the Assistant Secretary of Defense (Comptroller).

c. Naval Audit Service

The Naval Audit Service is the central audit agency for the Navy.

The mission of the Naval Audit Service is to perform internal audits of DON organizations, programs, systems, activities, functions and funds and to issue reports on these audits that describe conditions found and any corrective actions needed. [Ref. 16]

The major focus of the Naval Audit Service is concentrated on large, high-dollar value, multi-function program audits. As a result, the audit may take up to a year or more to complete.

The Naval Audit Service performs other functions, such as providing audit policy guidance, surveillance, and review of audits conducted by nonappropriated fund organization auditors; monitoring Department of the Navy contracts for audit services to ensure compliance with DOD guidance; supporting the Naval Inspector General in executing the Department of the Navy Audit Follow-up Program; serving as the focal point for internal audit policy relative to the Department of the Navy Management Control Program, and providing audit assistance to the Naval Investigative Service Command. [Ref. 17:p. 2]

Additionally, a limited management consulting service is available upon request. This service differs from an audit because the report remains confidential and is not released to outside parties.

The Auditor General of the Navy determines whether the management consulting service is more appropriate than an audit. The Naval Audit Service will recommend an audit if the initial investigation determines fraud or waste may exist, and will immediately prioritize the consulting request into the audit plan. When resources become available, an audit will be conducted. [Ref. 18]

The Auditor General of the Navy, a career civil servant, is directly subordinate to the Under Secretary of the Navy and serves in three capacities: Auditor General of the Navy; Director, Naval Audit Service; and Executive Staff Extension of the Under Secretary of the Navy. [Ref. 17:p. 2]

Appendix B discusses the current operational and organizational structure of the Naval Audit Service, and provides selections from the current audit plan.

d. Naval Investigative Service Command (NIS)

NIS maintains specialized fraud units throughout the world to investigate fraud and criminal activities. [Ref. 19] Auditors are not trained to perform criminal investigations. If potential evidence of fraud or other criminal activity is uncovered during an audit, the auditor can expand the scope of the audit to verify the evidence. If verified, the auditor furnishes a written report of the suspected activities to the director or director's superior, the Naval Inspector General and Naval Investigative Service Command for investigation.

The NAVIG and Naval Investigative Service Command then will determine at what level to brief any known or suspected instances of illegal actions. Where criminal activity is suspected during the audit, any notification or dissemination of audit reports will be coordinated with the Naval Investigative Service Command. This is to preclude compromise of the investigation or destruction/alteration of evidence. [Ref. 17:p. 7]

F. INTERNAL ASSESSMENT PROGRAMS

These reviews are conducted by personnel attached to the command.

1. Internal Review

Internal Review provided Commanding Officers an internal asset to assess the economy and effectiveness of their command functions. The reports generated by the

command's Internal Review staff were for the Commanding Officer's sole use and were strictly confidential. This gave the Commanding Officer the flexibility to direct the Internal Review staff to review areas of concern without delay. Since the results of these reviews remained within the command, the Commanding Officer could be assured of confidentiality thus providing an incentive for self-identification and correction of command problem areas.

In 1989, SECNAVINST 7510.9 canceled Internal Review as a required program; however Commanding Officers remain responsible for their command's economy and efficiency. They have the option of organizing their staff to perform reviews in a manner which is most effective for the command.

SECNAVINST 7510.9 requires any review termed "audit" to comply with GAO and Naval Auditing Standards, be performed by professional auditors and reviewed by the Navy Auditor General. When this occurs, the review no longer is confidential and can be made available to outside, interested parties. Since these reviews were initially intended to be a confidential management tool for the commanding officer's sole use, the majority of commands have replaced the term "audit" with "study," "evaluation," "review," "inspection," or "quick look"; and have changed the job series classifications of their review staff from GS-511 (Auditor) to GS-510 (Accountant) or CS-343 (Management Analyst). However, interviewees stated they will continue to follow the audit standards.

Economy and efficiency reviews "focus on areas to reduce costs of operations, increase production and eliminate waste, fraud and abuse." [Ref. 20:p. 2] Areas generally covered include the appropriated and non-appropriated activities for financial compliance. Major echelon commanders have developed specific policy and guidance in this matter.

Commands are required to provide an audit liaison service for outside agencies to conduct audits, reviews and inspections.

Liaison includes the following:

1. providing administrative support;
2. arranging for suitable office space and equipment;
3. coordinating dates, times and locations for entrance and exit conferences;
4. determining points of contact within various functional areas;
5. maintaining pertinent records;
6. coordinating management responses to findings and recommendations; and
7. coordinating audit resolution efforts between audit agencies and managers. [Ref. 21:p. 4]

2. Management Control Program

a. Definition

The Management Control Program is the formal process of an organization which evaluates whether internal controls exist and are effective throughout the organization. The Management Control Review is "a detailed examination by a responsible manager on an area to determine the adequacy of controls and to identify and correct deficiencies and weaknesses." [Ref. 22:p. 1] This is a "do-it-yourself" type program, where managers assess the control system. Management

controls are in compliance with the program if they follow the objectives of internal controls:

1. The Accounting control is responsible for safeguarding resources and assuring accuracy and reliability of information.
2. The Administrative control assures adherence to laws, regulations, and policies and also promotes efficiency and economy. [Ref. 23]

b. The Basic Program

The basic program consists of six steps.

(1) Assign Management Responsibilities. The Commanding Officer has overall responsibility for the program and must sign all reports, or in his/her absence, the Executive Officer may sign. All line managers perform assessments and reviews or document the reviews and testing of controls performed by audits, inspections or other reviews.

(2) Segment the Organization. Segment the organization into meaningful assessable units. An assessable unit is any entity capable of being evaluated by management control procedures, for example, minor property. These units should relate directly to a responsible manager.

(3) Risk Assessments. Risk assessments determine the susceptibility or vulnerability of a program to mismanagement due to fraud, waste or abuse.

Assessments are a quick look at an assessable unit, based on an individual's (manager's) knowledge, experience, and personality. Yes, even personality because the applicability and degree of adequacy or acceptability varies with each individual. But given the same information the overall results of an assessment will generally fall in the same range of vulnerability. [Ref. 23]

The Vulnerability Assessment Form (Navcompt Form 2283) (see Appendix C for an example) analyzes the general control environment, the inherent risk and existing safeguards or controls. The Vulnerability Assessment Form is suggested but not mandatory. However, an alternative risk assessment must follow the intent of the OMB guidelines.

The alternative risk assessment is based on the results of audits, IG inspections, or reviews, and the manager's knowledge and experience. Specific documentation is required concerning how the alternative risk assessment was performed and what was considered.

(4) The Management Control Plan. The Management Control Plan is a brief plan, updated annually, which gives the number of risk assessments, the number of reviews planned based on the list of assessable units, their risk ratings and how the evaluations are to be performed. This plan schedules control evaluations over a five-year period and is tied to IG inspections and annual audits to avoid duplication of efforts.

(5) The Management Control Review. The Management Control Review is a detailed review examining the general control conditions, within the event cycles. An event cycle is "series of steps taken to get something done" [Ref. 24:Encl, p. 1] or the steps used to accomplish the goals of the unit. This includes all the documents and activities needed to take a process from start to finish. [Ref. 23] It is conducted by the responsible manager to identify weak or

excessive controls and to provide appropriate corrective actions. Excessive controls are inefficient because the cost for maintaining the controls exceed the benefits achieved.

All assessable units must be reviewed during the five year cycle regardless of the risk factor. Functions which have a high risk factor are required to be reviewed within the first two years of the five year cycle. A low or medium factor may or may not require a review during the first two years, depending on the directions from the chain of command. [Ref. 23]

(6) The Annual Management Control Certification Statement. The Annual Management Control Certification Statement (see Appendix C) is sent to the next higher level in the chain of command documenting accomplishments, material weaknesses, the risk assessment report and management control plan. Proof of corrective actions taken must be attached to the statement.

If the deficiency has not been corrected, a statement of dollar value, potential level of risk and adverse publicity which could result if the weakness continues must be attached. Milestones with estimated completion dates are also required. Any weakness or potential loss of more than five percent of current resources should be considered for reporting to the next level in the chain of command. Criteria used to determine the materiality of weaknesses are provided in Appendix D. [Ref. 23]

Appendix E is a selected list of DON material weaknesses reported to the Secretary of Defense in 1989.

c. Regulations

The Federal Managers' Financial Integrity Act requires the head of each agency to submit annual statements to the President and Congress on the status of internal controls. OMB Circular A-123 prescribes government-wide policy for internal control systems in all government operations.

The Under Secretary of the Navy establishes program policy for the Department of the Navy. A Review and Oversight Council exists, among other objectives, to ensure DON weaknesses are promptly corrected. The Naval Audit Service, and Naval Inspector General evaluate compliance with the program.

For more detailed information concerning this program, consult SECNAVINST 5200.35B and OPNAVINST 5200.25B.

3. Other Command Audits, Reviews and Cash Counts

Although called audits, these are actually cash count verifications and should be of a surprise, irregular nature occurring not less than once each quarter. For these funds, managers can reduce the potential for fraud, waste and abuse by separating duties such as having different staff receive, count, record and deposit the money.

a. Imprest Fund

The imprest fund cashier is an individual appointed by the Commanding Officer for the purpose of making authorized cash payments for materials and services and is responsible for maintaining custody of funds and filing periodic vouchers to account for and replenish the fund. Disbursing personnel cannot be cashiers. [Ref. 25]

The NAVMILPERSCOMINST 7510.2A AND NAVCOMPT Manual Volume 4 provide direction for the imprest fund and audit requirements.

b. Non-Appropriated Funds

These funds include Morale, Welfare and Recreation (MWR) funds and Non-MWR funds such as the chapel funds, and bachelor quarters funds.

OPNAVINST 1730.1B provides guidance for use of chapel funds.

NAVMILPERSCOMINST 7510.2A provides guidance for Bachelor quarters funds and Morale, Welfare, and Recreation Funds.

According to the Director for MWR Auditing, Naval Military Personnel Command (NMPC), the following agencies are available for the Commanding Officer's use for auditing the MWR program.

- Internal assets such as audit boards or qualified staff. A potential problem with these assets is the lack of independence to the command. Also, most commands use collateral duty personnel who are unfamiliar with the

accounting system and may not perform the audit with proficiency.

- Echelon Two Commanders routinely audit the program. The Commanding Officer can request an accelerated review outside the normal schedule.
- Naval Investigative Service can perform special investigations. This report will stay within the command if no criminal activity is suspected.
- Navy Audit Service (at cost to the command) or NMPC Fiscal Oversight can review weaknesses and disclose compliance with directives.
- The use of Certified Public Accounting firms (at cost to the command) require advance approval from the Auditor General of the Navy. [Ref. 26]

This chapter discussed the topics of management control and auditing in the Navy. The next chapter will define audits, provide audit standards and discuss the audit process.

III. AUDITS AND STANDARDS

This chapter defines audits, provides audit standards and discusses the audit process.

A. AUDITS DEFINED

An audit is the process by which an independent and competent person examines a sampling of the actual practices of the entity under study and compares these practices to the policies and directives established by higher authority and generally accepted accounting principles. As defined by DOD,

...auditors independently and objectively shall analyze, review, and evaluate existing procedures, controls, and performance relating to organizations, activities, programs and functions; and shall present conditions, conclusions, and recommendations constructively in such a way as to stimulate or encourage corrective action. [Ref. 11:p. 4]

1. Financial Audits

A financial audit determines

...whether the financial statements of an audited entity present fairly the financial position, results of operations, and cash flows or changes in financial position in accordance with generally accepted accounting principles, and whether the entity has complied with laws and regulations for those transactions and events that may have a material effect on the financial statements. [Ref. 1:p. 2-1]

The auditor's conclusions are expressed as an opinion of the entity's performance in relation to policies and principles. Therefore, the opinion cannot attest as to whether the financial statements are completely accurate, only

that they represent the actual performance of the organization. In conducting the audit, the auditor tests the control system and attempts to determine whether the financial statements are an accurate portrayal of events, whether the organization followed the generally accepted accounting procedures and general policies and laws. If the organization did these to the best of the auditor's knowledge and ability to test them, then the opinion will report that the statements are fair.

2. Performance Audits

Performance audits include economy and efficiency and program audits. Economy and efficiency audits include determining whether the entity is acquiring, protecting and using its resources economically and efficiently, the causes of the inefficiencies or uneconomical practices and whether the entity has complied with laws and regulations concerning matters of economy and efficiency.

Program audits include determining the extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved, the effectiveness of organizations, programs, activities, or functions, and whether the entity has complied with laws and regulations applicable to the program. Generally, at the completion of a performance audit the auditor does not express an opinion on the overall level of performance. Rather, the auditor would report findings and conclusions on the extent and adequacy of performance and on specific processes, methods, and internal controls that can be made more efficient or effective. If potential for improvement is found, the auditor would recommend appropriate corrective actions. [Ref. 1:pp. 2-3--2-5]

B. ESTABLISHING AUDITING STANDARDS

Three standards boards enact the generally accepted accounting principles. The Governmental Accounting Standards Board (GASB) establishes accounting principles and financial

reporting standards for state and local government entities. The General Accounting Office (GAO) institutes accounting principles and financial reporting standards for the federal government. The Financial Accounting Standards Board (FASB) enacts accounting principles for nongovernment entities. [Ref. 1:p. 2-1, Footnote 1]

All auditors who conduct audits on government functions are required to follow the Government Auditing Standards as defined in the GAO Government Auditing Standards booklet (the yellow book). These standards are similar to those developed by the American Institute of Certified Public Accountants (AICPA) for nongovernment auditors. The standards are divided between general and specific, field work standards. Consult the yellow book for a full discussion of the standards.

1. General Standards

Four general standards detail the requirements of government auditors and nongovernment auditors performing audits on government functions. The first three standards are identical to the standards established by the AICPA; the last standard pertains only to GAO audits.

The standards describe the independence of the auditor and the independence of the audit organization; the qualifications of the audit staff; the responsibility of due care; and the presence of quality control.

a. Independence

Independence is the ability of the auditor to be impartial, and to be viewed as impartial by cognizant third parties, in collecting and analyzing information and preparing an opinion relating to the statements. An auditor or audit organization can be viewed as independent if no personal, external or organizational impairments exists. [Ref. 1:pp. 3-8, 3-9]

Personal impairments jeopardize the auditor's ability to make an impartial examination of the function. Such impairments can include a prejudicial attitude to the audited function or members of that organization; political or social biases due to loyalty to a specific organization; financial, professional or personal interest in the audited organization; and prior or current service with the audited organization. Policies enable the auditor and audit organization to identify any personal impairments which would mar the objectivity of the auditor's work and opinion. [Ref. 1:pp. 3-8, 3-9]

External impairments reflect on the ability to make a free and unbiased opinion. They result from factors outside the control of the audit organization such as the level of funding provided to the audit organization, the time provided for conducting the audit, interference from the audited agency on scope of the audit or transactions examined,

or any external interference which impacts the objectives of the audit. [Ref. 1:pp. 3-8, 3-9]

Organizational impairments affect the audit organization as a whole. The causes of these can be attributed to such pressures as whether the organization reports directly to the director of the audited function, whether its personnel are hired, promoted, or fired on merit or political coercion. [Ref. 1:pp. 3-8, 3-9]

b. Qualifications of the Audit Staff

The combined staff should have the professional qualifications to competently perform an audit. This means that the audit organization as a whole must possess these qualifications not necessarily any one person.

If an organization employs personnel, or hires outside consultants, with acceptable knowledge and skills in such areas as accounting, statistics, law, engineering, audit design and methodology, automatic data processing, public administration, economics, social sciences, and actuarial science, each individual staff member need not possess all these skills and knowledge. [Ref. 1:pp. 3-1--3-2]

In order for the audit organization to maintain its proficiency and technical competence, the GAO standards require a program of continuing education and training for all auditors assigned to the organization who perform audit activities and services. [Ref. 1:pp. 3-1--3-2]

c. Due Professional Care

The auditor performs as a professional in all duties related to the audit. This includes but is not limited to defining the scope of the audit, ensuring the audited

entity understands the objectives of the audit prior to performing the audit, understanding the operations to be audited, choosing the appropriate methodology and tests used based on materiality or significance to the audit, the completion of the working papers, making inquiries concerning the expertise of external auditors or specialists assisting in the audit, rendering a sound opinion, and determining whether corrective action has been undertaken from previous audits if these affect the current audit. Each of these determines the quality of the final product. [Ref. 1:pp. 3-1--3-2]

This standard does not mean the auditor must make a perfect judgment or is infallible, nor does it imply the auditor assume extensive liability. [Ref. 1:pp. 3-1--3-2]

d. Internal Quality Control

This applies to government auditors who are required to follow the GAO guidelines. GAO standards require an

...external quality control review at least every three years by an organization not affiliated with the organization being reviewed. The external quality control review program should determine that the organization's internal quality control system is in place and operating effectively and established policies and procedures and applicable auditing standards are being followed in its audit work. [Ref. 1:p. 3-18]

The limits of an internal quality control system depend on the size of the firm, the nature of its work and the cost-benefit considerations given to a quality control program. [Ref. 1:p. 3-18]

2. Specific Standards

This section describes the supplemental field work standards for financial and performance audits.

a. Field Work Standards For Financial Audits

Financial field work standards have been developed by the AICPA. These are supplemented by the GAO Government Auditing Standards to assist auditors in government financial audits.

(1) Planning. "Planning should include consideration of the audit requirements of all levels of government." [Ref. 1:p. 4-1] This standard requires auditors to determine the final users of the audit and plan the audit to meet their legal and regulatory requirements.

(2) Compliance Tests. Not only should the auditor test compliance with the laws, but also test how not complying with the laws and regulations affects the financial statements or the results of the audit. The auditor should be predominately concerned with those laws and regulations which directly and materially affect the financial statements. [Ref. 1:p. 4-1]

The auditor should be cognizant of areas susceptible to fraud or other illegal acts and design audit tests to detect those which could have a material affect on the financial statements or the report of a financial audit. As part of the general standard of exercising due care, the auditor should extend the scope of the audit when evidence

indicates possible illegal acts or terminate the audit completely, turning over the evidence to criminal investigators. [Ref. 1:p. 4-1]

(3) Working Papers. These provide evidence of the audit work performed and the basis for the opinions expressed in the report.

(4) Internal Control Structure. The auditor needs a sufficient understanding of the internal control structure in order to plan the audit and associated tests. With financial audits, the auditor is concerned only with those controls which apply to the financial records or which the auditor uses in audit tests. [Ref. 1:p. 4-1]

b. Field Work Standards For Performance Audits

(1) Planning. Planning includes coordinating the activities with other agencies which may be involved to prevent double work and to centralize aspects of the work, such as the final report. A well-planned audit helps guarantee the costs associated with the audit are outweighed by the benefits attained. Initial surveys are recommended to adequately plan the audit scope. [Ref. 1:pp. 6-6, 6-7]

Audit scope is the boundary of the audit including the audit subject and performance standards. Objectives are what the audit attempts to accomplish and should be clearly and concisely documented. Methodology includes the tests, data gathering process and evidence collected during the course of the audit to show that the

objectives and scope have been accomplished. Performance standards should be reasonable, relevant and attainable. [Ref. 1:pp. 6-6, 6-7]

An audit program is developed for each audit. The audit program details the work among supervisors and staff, and provides the methodology and procedures to be used. As a minimum, audit programs should include:

- Introduction and background: Information should be provided about the legal authority for the audited organization, program, activity, or function; its history and current objectives; its principal locations; and similar information needed by the auditor to understand and carry out the audit program.

- Objectives of the audit: The objectives should be clearly stated.

- Scope of the audit: The scope should be clearly described.

- Audit methods: The methodology should be clearly described, and for most audits, it is desirable to include suggested steps and procedures, and sampling plans for the auditors to follow....

- Definition of terms: Any known unique terms used by the audited entity should be defined or explained.

- Special instruction:....This section of the program may be used to list the responsibilities of each audit organization, such as preparing audit programs, conducting audit work, supervising audit work, drafting reports, handling auditee comments, and processing the final report.

- Report: The audit program should set forth the general format (if not included in organization audit policy and procedures) to be followed in the audit report and cite, to the extent possible, the types of information to be in it. [Ref. 1:pp. 6-6, 6-7]

(2) Supervision. Supervision varies with the staff members' level of experience and is documented in the

working papers. This includes whether the objectives were achieved, the audit standards and audit program were followed, and whether the working papers substantiate the audit findings. Providing on-the-job training and continuing education are also included in this standard. [Ref. 1:p. 6-9]

(3) Compliance Tests.

An assessment is to be made of compliance with applicable requirements of laws and regulations when necessary to satisfy the audit objectives....Auditors should design the audit to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objectives....Auditors should be alert to situations or transactions that could be indicative of abuse or illegal acts. [Ref. 1:p. 6-9]

The auditor decides which laws and regulations pertain to the audit as well as those which will have a vital influence on the objectives. The audited entity is responsible for providing the pertinent laws and requirements for the auditor.

[Ref. 1:p. 6-11]

(4) Assessment of Internal Controls. This is required, if needed, to satisfy the audit objectives. The reasons and tests used to evaluate internal controls depend on the audit objectives. Not all audits will require an assessment of the controls. [Ref. 1:p. 6-13] GAO Government Auditing Standards necessitate examining the controls if the audit objectives require:

- testing the adequacy of particular internal controls.
- verifying the adequacy of the process for carrying out a particular mission or action.
- assessing unsatisfactory performance. [Ref. 1:p. 6-13]

(5) Evidence. Evidence has four categories: physical, documentary, testimonial and analytical.

Physical evidence pertains to the direct observation or inspection by the auditor. This can include observing events such as counting inventory; inspecting charts, graphs, maps, buildings etc., or other physical documentation of property; and observing people in action. This type of evidence is more reliable and valid than that which is obtained indirectly. [Ref. 1:pp. 6-16, 6-17]

Documentary evidence relates to the files of the organization reflecting performance. These are the memos, letters, accounting records, etc. The original documents are considered more reliable than copies. [Ref. 1:pp. 6-16, 6-17]

Testimonial evidence comes from interviews and correspondence written directly to the auditing service. If the evidence is significant to the audit, the auditor should also collect supporting information regarding the statements and the reliability of the source. The testimony can be considered valid and reliable when the person can speak without reprisals. [Ref. 1:pp. 6-16, 6-17]

Analytical evidence applies to the calculations, logic, and correlation of the information received. [Ref. 1:pp. 6-16, 6-17]

Once the auditor has the evidence, it must be tested for sufficiency, relevance and competence.

- Sufficiency is the presence of enough factual and convincing evidence to support the auditors' findings, conclusions, and any recommendations. Determining the sufficiency of evidence requires judgment. When appropriate, statistical methods may be used to establish sufficiency.

- Relevance refers to the relationship of evidence to its use. The information used to prove or disprove an issue is relevant if it has a logical, sensible relationship to that issue. Information that does not is irrelevant and therefore should not be included as evidence.

- To be competent, evidence should be valid and reliable. In evaluating the competence of evidence, the auditors should carefully consider whether reasons exist to doubt its validity or completeness. If so, the auditors should obtain additional evidence or reflect the situation in the report. [Ref. 1:p. 6-17]

The auditor can surmise the evidence is competent if it comes from a source independent of the audited entity; or if the internal control structure is strong. [Ref. 1:p. 6-17]

C. AUDIT PROCESS

Four stages occur in most audits, whether they are performed by the in-house auditors or audit agencies: planning, survey, verification and reporting.

1. Planning Stage

Preliminary research and preparation for an audit could best describe this phase. To control costs and to ensure an audit which will assist management effectively, an audit plan is developed. Limited value is attributed to even superbly conducted audits which provide meager or no benefits to management. In addition, audits which are broadly scoped cannot control costs effectively thereby diminishing the

results of the audit report. With increasing attention focused on government spending, it behooves the audit agencies to develop sound audit plans which can justify when and why certain areas are planned and audited or not planned and not audited. [Ref. 27:Ch. 5, p. 3]

a. Justification

The DOD Internal Audit Manual provides the following causes for justifying and prioritizing audits:

1. Sensitivity. The sensitivity of a program or system to the mission of an organization and the importance of that mission to the overall mission of its parent organization are important considerations. Other considerations include whether an area is of high interest to the head of the Department or organization or whether poor performance in an area could cause severe embarrassment to the Department or adversely impact on its relations with Congress.
2. Risk. The adequacy of internal control systems and the vulnerability of an area to fraud, waste, abuse or mismanagement is the major consideration in this area. Also, the newness of, or major changes in, programs and systems could increase the risks.
3. Audit Experience. Give a higher rating to an audit area that has a history of major deficiencies than to an area that has experienced only minor deficiencies in the past. Be sure to consider the results of other evaluations such as inspections, investigations and program reviews, along with the results of the most recent reviews by the audit activity, other DOD audit organizations, U.S. General Accounting Office (GAO), and commercial firms performing audit work on a contractual basis.
4. Financial Impact. Identify the current or potential dollars involved in the programs, system or function. This can be measured in various ways such as value of assets or amount of funding.
5. Time Since Last Audit. Consider the date of the last audit or comprehensive inspection and assign higher ratings to those with longer elapsed times since the last audit or comprehensive inspection.

6. Management Request. Assign additional rating points when management requests an audit of the area. [Ref. 27:Ch. 5, pp. 5-6]

b. Audit Plan

Planning and conducting the audit is the auditor's responsibility. The audit plan contains:

- the audit objectives and scope.
- the background of the proposed activity.
- written communication with all interested parties including the activity to be audited.
- resources required to perform the audit adequately.
- on-site surveys planned to develop familiarity of the program, to identify areas to emphasize, and to invite comments from the activity.
- approval of the work plan.
- coordinating the plan with other audit and review agencies to ensure similar audits are not planned or currently running. [Ref. 27:Ch. 2, p. 8]

2. Survey Stage

The survey stage is the refinement stage. For the Naval Audit Service, this phase encompasses approximately 30 percent of the total audit time. [Ref. 28] During this phase, the audit team determines whether sufficient evidence exists to perform an audit and attain monetary benefits in excess of costs. Approval to continue with the audit process is assigned to senior management based on the reports from the field auditors. [Ref. 27:Ch. 8, p. 4] This phase requires:

- familiarity with the program, planned area, and its policies and procedures. It provides auditors the opportunity to interview management for suggestions and comments, to identify areas of weakness or corrective

actions taken from previous inspections or audits, and to identify potentially significant findings for further study during the verification phase. This phase also develops or refines audit objectives and the scope of the work including site selection. [Ref. 27:Ch. 8, p. 4]

- the decision to proceed with the audit.

The audit program is then developed. The program will include the revised or established audit objectives; special instructions and definition of terms; background of the function to be audited including but not limited to location, mission, policies and procedures, and noted areas of deficiencies in the control program; purpose and scope of the audit as well as methodology, and the format and content of the report. [Ref. 27:Ch. 8, p. 4] If the audit program is effective, standardized procedures will then exist for multilocation audits. [Ref. 27:Ch. 8, p. 4]

3. Verification Stage

The actual audit field work occurs during this phase. The audit team provides an entrance letter to the component head, detailing the objectives and scope of audit and the period of time which the audit will cover. This letter provides ample notification for the entity to prepare for the audit. The auditors will request an initial interview with the command in which they will address their objectives and any concerns the command may have, including noted weaknesses which are being corrected, prior to beginning the actual work. No entrance letter is sent for cash counts or similar audits

where surprise is essential to the audit. For all audits, management will be advised when objectives are modified and when the audit progresses through each stage.

During this phase, the auditors collect the evidence needed to accomplish the audit objectives and to develop conclusions and opinions concerning the audited entity. Some of the evidence collected includes investigating prior audit recommendations and testing for corrective action. The prior audits need not have been performed by the same agency. Any previous audit is eligible. [Ref. 27:Ch. 8, pp. 5-8]

The auditors are responsible for developing their potential findings and recommendations as early in the audit as possible and discussing these with the audited entity's officials, before they are in the formal draft. The findings must relate to the objectives. If management takes corrective actions on the potential findings, this action will be reflected in the report as well as any corrective actions taken prior to the audit. [Ref. 27:Ch. 8, pp. 5-8]

A draft report will be presented to the activity prior to the end of the audit or within 60 days of completion of the field work. This report clarifies any discussions with management, provides management the opportunity to refute claims of benefits associated with the findings and in the process reduces the possibility that management will reject the report. [Ref. 27:Ch. 8, pp. 5-8]

The exit conference is management's final occasion to discuss disputed matters with the auditors before the formal draft is written. If this conference occurs before management has a chance to see the draft report, another conference will be offered, if desired. [Ref. 27:Ch. 8, pp. 5-8]

The final step in this process is the post-audit critique which is designed for management to provide feedback for improving audits of the type just performed. [Ref. 27:Ch. 8, p. 8]

4. Reporting Phase

The audit report is the formal written document which describes the results of the audit process. Included in this document are the auditors' opinions and recommendations for improving material deficiencies. All audit reports follow the standards established by the AICPA and the GAO Government Auditing Standards.

a. Financial Audit Reporting Standards

The first four standards for reports of financial audits and financial related audits require a statement that:

- the audit was made following generally accepted government auditing standards (GAGAS). This refers to the standards described in the yellow book. [Ref. 27:p. 12-2]
- a test was conducted for compliance with laws and regulations. The compliance statement will be in the form of a positive or negative assurance. A positive assurance indicates the test was performed and there appears to be compliance with the laws. A negative assurance indicates that nothing appears to indicate noncompliance in the items not tested. This statement on compliance will indicate whether illegal activities

identified through the audit could result in criminal prosecution. A noncompliance statement will be issued if necessary. [Ref. 27:p. 12-2]

- concerns the auditors' assessment of the internal control structure. This statement will detail the scope of the work involved to garner an understanding of the control environment, tests of the controls and the report of the condition of the controls.

An assessment need not be made but must be reported, if:

- a. the size of the audited organization is small,
 - b. the control structure is so weak that the auditor had to rely on other tests,
 - c. it was more efficient to conduct other tests, or the audit objectives did not require an evaluation of the internal controls. [Ref. 27:p. 12-2]
- some information which forms the auditors' opinions may be prohibited by law from disclosure. If this is the case, the auditor will describe the nature of the work and the basis for the nondisclosure in the audit report. [Ref. 27:p. 12-2]

The fifth standard covers distribution and timeliness of the audit report. Timeliness, for DOD, means within 120 days following the draft report. [Ref. 27:p. 12-2] Generally, unless the report is classified for security or ethical reasons, it is made available to all interested parties for inspection.

b. Performance Audits

Performance audit reports will include the statements as described above on compliance with GAGAS, assessment of internal controls, compliance with laws and regulations, disclosure and distribution requirements.

In addition the report will have a statement describing the audit scope, objectives and methodology. Audit findings and conclusions should be relevant, competent and sufficient. The findings and conclusions will be clearly stated. Any background information for which an interested third party may need to understand the report will also be included. [Ref. 1:p. 7-15]

Where weaknesses and deficiencies are noted, the auditor will provide the cause of the problem identified and supporting evidence. Beneficial and practical recommendations when required by the audit objectives will be made if corrective action will significantly affect the organization. Any uncorrected actions from previous audits will be reported. Auditors are advised to address their specific recommendations in a constructive, performance-directed manner to those officials capable of taking action. [Ref. 1:p. 7-15]

Performance audit reports will provide for appropriate remarks by accountable officials on action taken or contemplated concerning the findings and conclusions. The auditor will normally request these remarks in writing to avoid possible misinterpretation. [Ref. 1:p. 7-15]

The report will note if the audit uncovered any management achievements, especially if these applied to other areas of the audited entity, "inclusion of such accomplishments may lead to improved performance by other government organizations that read the report." [Ref. 1:p.

7-11] Any areas requiring further study but not associated with the audit objectives under examination, will also be noted in the report. [Ref. 1:p. 7-15]

The performance audit report will be "complete, accurate, objective, and convincing, and be as clear and concise as the subject matter permits." [Ref. 1:p. 7-12] Complete refers to the information provided, the perspective of evidence to the findings, and if required, supporting documentation for the reader to correctly understand the organization's performance. An accurate portrayal refers to ethical and professional work. An audit agency maintains integrity in its working papers if evidence is relevant and competent to the audit scope, objectives and methodology. [Ref. 1:p. 7-15]

Objectivity is the impartial manner in which the audit is conducted, the facts presented, and the report written. A professional report will keep findings and conclusions in perspective. Behavior modification is always the reason for the recommendations. Therefore, the auditor will address the report in a constructive manner so as to be helpful. [Ref. 1:p. 7-15]

Convincing, clear and concise requires the auditor to present the report in a manner which is easy to read, whose conclusions follow logically from the facts and audit objectives, providing any necessary supporting documents such as charts or graphs which will make it easier to understand.

The report will be long enough to cover the audit without being redundant; a complete, concise report will receive greater attention. [Ref. 1:p. 7-15]

c. Follow-up

The auditors check for corrective actions on known findings and recommendations from previous audits which could affect the findings of the current audit. During this check, they also ascertain whether optimum benefits were attained in a timely manner. [Ref. 1:p. 7-15]

Follow-up for auditors also occurs after their report is issued. They verify management's responses are made within 60 days of the draft report or 60 days following release of the final report. If a deficiency requires immediate action, the timeframe for responses will be indicated in the report. The second part of follow-up requires the auditor to review the management's responses according to DOD directives. Management is compelled to concur or not concur with each audit finding, recommendation and monetary benefit. The audited entity may indicate whether alternative action is more appropriate and provide their proposal. Management is also compelled to provide any corrective action taken and a plan of action on those findings and recommendations where corrective action has not been taken. The plan of action will also indicate estimated dates of completion and monetary benefits anticipated. [Ref. 1:p. 7-15]

Specific guidelines for resolving disputes are provided within DOD Directive 7650.3.

This chapter defined audits, provided audit standards and discussed the audit process. The next chapter will discuss practical suggestions for managers to prepare for and participate in audits or reviews.

IV. PRACTICAL GUIDELINES FOR A SUCCESSFUL AUDIT

This chapter discusses practical suggestions for managers to prepare for and participate in audits or reviews.

A. PREPARING FOR AN AUDIT OR INSPECTION

Once notified, the following steps are recommended. Usually the manager will have several months notice of a pending audit or inspection. The manager should:

- Review the areas of special interest issued in the audit plan, and understand the objectives and scope of the audit or inspection. Will it be an activity level compliance audit or will its focus be narrowed to a specific program? If it will be a multi-location audit, the manager will require more specific preparation.
- Review prior inspection and audit findings for areas of potential weaknesses, since auditors look at results and recommendations from previous audits. If these have been reported corrected but the deficiencies still exist, managers must take immediate action to correct the situation.

Prioritize the discrepancies requiring corrective action according to the level of risk and vulnerability to the mission of the command. Two audit findings are considered the worst kind: repeat audit findings when corrective action was reported earlier, and new audit findings identifying a weakness of which the manager was unaware.

- Perform a mini-audit, examination or review on the function. Is there compliance with the required standards, directives, etc.? If the Management Control Review has been conducted correctly, there should be few, if any, surprises.

B. PARTICIPATING IN AN AUDIT

1. Professionalism and Cooperation

Cooperation in attitude is extremely important. The manager should assume a professional stance.

Be helpful. Assist the auditor with access to requested information. However, limit access to the requested information only, so weaknesses can be attributed exclusively to that file.

Provide status on apparent deficiencies and any corrective action which has been taken. If the problem is obvious, the auditor will find it anyway. Ask for advice on how to correct problem areas, especially during survey audits. The auditor's job is to assess the function and make corrective recommendations.

The Naval Audit Service indicates some managers have been known to conceal vital information to an audit only to turn it over during the exit conference. [Ref. 28] Managers maintain their credibility with the auditors if they are honest and are not concealing information. When the manager loses credibility, the auditor relies on evidence obtained elsewhere.

Provide an area for the auditor to work uninterrupted. Since the auditor is unfamiliar with the physical organization, the manager should provide a layout of the building.

Assist in scheduling meetings and interviews with key personnel. This also requires the manager to have key personnel available during the audit, scheduling leave and travel appropriately.

Ensure the staff has been trained to comply with directives and instructions so the auditors receive the same information from all. Other ways to participate include asking questions of the auditors to clarify information or to understand the work and tests performed. Keep the chain of command informed of the progress and any important developments or findings which could reflect adversely on the command.

2. Auditee's Bill of Rights

An audited organization has certain rights during an audit.

a. Right 1

To know the scope, schedule and objectives of the audit or any changes to these. The auditor is required to provide this information at the entrance interview.

b. Right 2

To conduct its work with minimal interference. The audited entity should provide a point of contact if the auditor requires assistance outside the interview schedule.

c. Right 3

To ask questions of the auditor or request clarifying information pertaining to the audit at any time.

The organization has the right to understand the audit process including the methodology, tests and findings.

d. Right 4

To read the report before final release. This is extremely important. If there are disagreements, the manager should make them known. Indicate concurrence or non-concurrence to each finding, in writing. Major claimants have been known to mark budgets based on a manager's concurrence with the findings. If the manager does not concur, provide supporting evidence for the non-concurrence. This is the manager's last opportunity to question the findings and tests.

[Ref. 29]

3. Audit Follow-up

Design a tickler system to track each finding until corrective action has been taken and verified. This tickler system furnishes information which indicates the organization's position on the findings, corrective action taken and whether the actions corrected the noted deficiencies. It also indicates monetary benefits achieved and how these correspond to the audit report. Finally, the tickler file provides a plan of action including dates for corrective action and completion of those areas not readily corrected. The tickler file remains open until the corrective actions have been taken and confirmed or verified.

The tickler file should be made available for all interested entities to perform new audits, reviews, etc.,

based on the status of the audit report. All documentation remains in the follow-up files for further reviews. [Ref. 30:p. 6]

C. USING AUDIT AND REVIEW ASSETS EFFECTIVELY

Judicious use of internal assets, such as former internal review personnel, accountants, or management analysts, promotes better management. When you ask functional leaders to report on their areas, you get what you inspect. [Ref. 31] Managers are reluctant to report weaknesses for which they cannot correct promptly.

Internal assets, audits and reviews keep people honest. If they know they will be inspected, they are more likely to follow established guidelines.

Internal assets can also investigate Commanding Officer's hot-line issues. If these issues are of significant concern or dollar amounts, the Commanding Officer can address them further in economy and efficiency reviews, or audits.

Whether to perform economy and efficiency reviews on a periodic basis or at the beginning/end of tours is a management decision. Some prefer the periodic basis which provides the manager the opportunity to correct the problems before detaching. They also feel that since other employees are still in that functional organization, new standards can be developed at any time. Others prefer the entrance/exit review as a measure of the efficiency and effectiveness of the

outgoing manager, and for establishing a new set of standards for the new manager to follow.

D. MANAGEMENT CONCERNS

Most commands report the discrepancies noted in audits are the result of not having adequate numbers of staff or time to do everything which is required. Fraud, waste, abuse or mismanagement are not the typical culprits. The manager makes the decision by default on which requirements are more important and which can be relegated to second place until time permits. Most interviewees said they have good people doing a good job the way they were trained. The training and time to perform the job could be improved.

A second concern affects the topics audited. The managers feel the topics are not necessarily the big dollar items, such as those which have the largest budgets but are more often the result of political and media events. Often, the small funds, such as Morale, Welfare and Recreation (MWR) funds and chapel funds receive the greatest attention due to their high visibility and risk status since they handle cash transactions. According to one interviewee, five percent of the audits are spent on a function which uses 60 percent of the budget, and 30 to 40 percent of the audit time is spent on chapel funds and MWR. Additionally, directives are sometimes behind the times, as in MWR requirements. However, these outdated directives are the only source for auditors to rely

upon when checking compliance. [Ref. 31] Other interviews provided similar information.

E. CONCLUSION

Taxpayers are becoming increasingly concerned with how the government spends its money, particularly in defense-related areas. With constant discussions concerning the spiraling budget deficit and resultant interest payments, the media and taxpayers are demanding closer scrutiny of the budget and how government funds are spent.

Congress attempts to control wasteful spending through budget restraints. For instance, audit reports generally recommend various savings and benefits. Theoretically, if the recommendations are enacted by the auditee, budget savings should accrue. However, if these recommendations are not implemented, Congress can restrict the budget to the amount of the projected savings under the assumption that an efficiently-managed program would require less funding.

APPENDIX A

COMMON/RECURRING DISCREPANCIES FOUND DURING COMMAND INSPECTIONS

This is an abbreviated list of recurring items discovered during command inspections by major claimants.

- Failure to maintain an active energy conservation and awareness program to meet CNO energy management objectives by not taking advantage of energy reduction projects, conducting quarterly energy conservation committee meetings, developing an energy improvement plan and instituting an awareness program.
- Failure to implement a Military EEO Program and ensure that Navy Rights and Responsibilities Workshops are conducted.
- Failure to develop adequate performance standards and elements in that they are too vague or general, unrelated to duties described in position descriptions, not measurable, or address conduct rather than performance.
- Failure to implement an effective Internal Controls Program wherein reviews are properly documented.
- Failure to adequately test internal controls while conducting Management Control Reviews (MCRs).
- Failure to establish adequate controls for monitoring the use of overtime.
- Failure to comply with Occupational Safety and Health training requirements for all categories of personnel.
- Failure to establish a strict key and lock control program.
- Failure to develop and publish a comprehensive Physical Security Plan.
- Failure to develop and/or maintain an updated Oil Spill Prevention Control and Countermeasure Plan for fuel

storage facilities to identify potential sources of petroleum spills.

- Failure to initiate proper tracer action on inbound household goods shipments which do not arrive by the required delivery date in order to determine current location, status, and new estimated time of arrival.
- Failure to establish adequate controls for disposal proof of shipment/proof of delivery processing in order to account for transfer of shipments to the Defense Reutilization and Marketing Office (DRMO).
- Failure to process interfund billings in a timely manner. [Ref. 32]

APPENDIX B
NAVAL AUDIT SERVICE

The Naval Audit Service is divided into four directorates: Management Resources Directorate; Plans and Policy Directorate; Audit Operations Directorate; and Management Consulting Directorate. Audit coverage is divided into four regions: Western, Northeast, Capital and Southeast. In addition to the Navy Audit Service Headquarters and the Regional Headquarters, auditors can be found in the following locations:

- SYSTEMS COMMANDS AND HEADQUARTERS ACTIVITIES.
- INVENTORY CONTROL POINTS.
- SHIPYARDS.
- AVIATION DEPOTS.
- SUPPLY CENTERS.
- FINANCE CENTERS.
- MARINE CORPS BASES.
- RDT&E/ENGINEERING ACTIVITIES.

With a FY-1990 budget of \$28.8 million, 554 civilian personnel (primarily in the GS/GM-511 Auditor series), generated about 700,000 direct audit hours.

The Naval Audit Service was heavily criticized by GAO and DOD IG in 1986-7 for recommending \$6 million in potential benefits while spending \$26 million and lacking documented

supervision and quality control. Designating military officers as deputy auditor general and regional office directors created the perception of reduced audit independence and a potential conflict of interest with future supervisors.

Senior Navy Auditor concerns centered on the considerable amount of resources expended to complete audit guides and prepare workpapers for areas which contained little or no audit potential. The Navy Auditor General dedicated 29 percent of available audit hours in FY86 to single-activity, compliance audits. [Ref. 3:p. 12-14]

As a result of the GAO findings, the Naval Audit Service restructured itself, providing extensive supervision and quality control. Military directors were replaced with SES/GM-15 civilian directors to counter possible conflict of interest and audit independence concerns.

Standardized audit programs were discontinued and a unique audit program was designed for each audit. Mission effectiveness and efficiency replaced compliance as the primary audit objective. The by-products could be savings and readiness. Savings are defined as: 1) recurring (annual recurring) or non-recurring (one time savings, such as when the program is canceled), and 2) collections from overpayment. [Ref. 18]

The Naval Audit Service also developed an audit-by-objectives approach. This management technique forces auditors to attend to the objectives throughout the audit process, refining them when necessary. It requires a conscious decision to progress to each stage of the audit

process. The basic elements of the audit-by-objectives approach entail:

- Establishing specific audit objectives and, if appropriate, a general audit objective for every audit.
- Refining the audit objectives during the planning and survey phases of the audit based on information gathered during each phase.
- Making a formal decision to either continue or curtail the audit at the end of the planning phase and the survey phase before beginning field verification.
- Developing an audit plan to achieve the established audit objectives and produce potential findings and recommendations.
- Structuring the audit approach to determine whether a major problem exists, the extent of the problem, the basic cause of the problem, and to formulate workable solutions.
- Reevaluating the audit approach during the early stages of verification.
- Effectively controlling the audit with a series of go or no-go decision points before beginning each audit phase. High level audit management shall be involved at the decision points at the start of the audit, at the end of the survey phase, and at the end of the field verification.
- Summarizing audit results in the form of conclusions about the general objective, if there is one, and about each specific objective. [Ref. 27:pp. 3-4]

A. AUDIT PLAN

The audit plan generally covers current high interest issues. [Ref. 16] A limited selection of the 1990 audit plan is included in Section B of this appendix.

The Naval Audit Service also performs an independent appraisal as part of its annual audit plan to determine whether the Management Control Program and policies are

followed, and identified weaknesses are adequately corrected. According to the Director for Audit Policy at the Naval Audit Service, the Management Control Program is assessed twice. Each program audit determines whether the Management Control Program is accomplishing its goal and how the program affects the audit results. The second assessment occurs when the Navy reports its annual weaknesses. Auditors visit sites and look at opinions and weaknesses to ensure nothing is concealed or hidden. [Ref. 18]

B. NAVAL AUDIT SERVICE INTERNAL AUDIT PLAN

This is a selected list of planned or ongoing audits for 1990.

Hazardous Waste Management.

Objectives: (1) evaluate hazardous waste management as related to transportation, treatment, reuse, recycling, and disposal; (2) evaluate accuracy of hazardous waste generation reporting; (3) evaluate hazardous material acquisition and storage practices; (4) determine adequacy of hazardous waste management training, staffing, and funding; and, (5) evaluate the ability of the Navy to effectively comply with federal, state, and local jurisdictional requirements.

DON Management Control Program, Accounting Systems Review Process, and the Efficiency Review Program.

Objectives: (1) determine the reasonableness and propriety of the FY 1989 DON Management Control Certification Statement, (2) assess the basis for reporting accounting systems in substantial compliance with prescribed principles and procedures, and (3) determine the extent of the implementation of the DON Efficiency Review Program.

Follow-up on Audit of Navy Budget Clearing Accounts.

Objectives: determine if (1) Navy management took action in response to our prior audit of Budget Clearing Accounts, and (2) those actions corrected the reported deficiencies.

Development and Implementation of the Automated Standard Civilian Payroll System (NAVSCIPS).

Objectives: determine whether (1) the NAVSCIPS project objectives are being effectively and efficiently accomplished, and (2) the requirements for NAVSCIPS can be economically justified.

Budgeting and Contracting for Navy Base Operating Services.

Objectives: determine (1) if budgeted funds adequately support operational requirements, (2) if contract award procedures are proper, (3) if work and services billed are actually performed, (4) if contractors are properly paid, and (5) if the contract administration function is otherwise properly performed.

Manage-to-Payroll in the Navy.

Objectives: determine (1) if Manage-to-Payroll is a viable method of controlling civilian payroll costs, (2) if commands have adequately implemented Manage-to-Payroll, and (3) if personnel resources are managed efficiently and effectively under the program. [Ref. 33]

APPENDIX C

EXAMPLES OF VULNERABILITY ASSESSMENT FORM AND BASIC CERTIFICATION LETTER

The following pages provide examples of the vulnerability assessment form and format for the basic certification letter as suggested in SECNAVINST 5200.35B, dated 25 March 1988.

VULNERABILITY ASSESSMENT FORM

1. ORGANIZATION:		2. ORGANIZATION CODE:	
3. PROGRAM/ FUNCTION/ ACTIVITY (ASSESSABLE UNIT)			

GENERAL CONTROL ENVIRONMENT

4. EMPHASIS ON INTERNAL CONTROLS:	CHOICE	VALUE
MAJOR EMPHASIS		(1)
MODERATE EMPHASIS		(3)
MINOR EMPHASIS		(5)

5. COVERAGE BY WRITTEN PROCEDURES:	CHOICE	VALUE
SPECIFIC GUIDANCE W/ LITTLE OR NO DISCRETION		(1)
FLEXIBLE GUIDANCE W/ SIGNIFICANT DISCRETION		(3)
NO WRITTEN PROCEDURES		(5)

6. SPECIFYING GOALS AND MEASURING ACCOMPLISHMENTS:	CHOICE	VALUE
NOT APPLICABLE		
GOALS/OBJECTIVES FORMALLY ESTABLISHED AND MONITORED		(1)
GOALS/OBJECTIVES USE INFORMALLY OR W/ LITTLE FOLLOWUP		(3)
GOALS/OBJECTIVES NEEDED BUT NOT ESTABLISHED		(5)

7. ADEQUACY OF CHECKS AND BALANCES:

CHOICE	VALUE
NOT APPLICABLE	
ADEQUATE	(1)
NEEDS IMPROVEMENT	(3)
REQUIRED BUT TOTALLY LACKING	(5)

8. ADP USED FOR REPORTING OR OPERATIONAL DATA:

CHOICE	VALUE
NOT APPLICABLE	
DATA RELIABILITY (TIMELINESS, ACCURACY) AND SECURITY ARE SATISFACTORY	(1)
DATA RELIABILITY OR SECURITY NEEDS SOME IMPROVEMENT	(3)
DATA RELIABILITY/SECURITY IS A MAJOR PROBLEM	(5)

9. PERSONNEL RESOURCES

CHOICE	VALUE
ADEQUATE NUMBER OF QUALIFIED PERSONNEL	(1)
ADEQUATE NO. OF PERSONNEL BUT SOME TRAINING REQUIRED	(3)
INSUFFICIENT NO. OF PERSONNEL OR MAJORITY OF STAFF LACKS QUALIF. OR NEEDED TRAINING	(5)

ANALYSIS OF INHERENT RISK

10. PROGRAM ADMINISTRATION:	CHOICE	VALUE
DON ONLY		(1)
JOINT SERVICE		(3)
THIRD PARTY (CONTRACTOR)		
• HEAVY INVOLVEMENT		(4)
• TOTAL INVOLVEMENT		(5)

11. SCOPE OF WRITTEN AUTHORITY:	CHOICE	VALUE
PRECISE		(1)
CLARIFICATION REQUIRED		(3)
NO WRITTEN AUTHORITY		(5)

12. AGE/STATUS OF PROGRAM:	CHOICE	VALUE
RELATIVELY STABLE		(1)
CHANGING		(3)
NEW OR EXPIRING WITHIN 2 YEARS		(5)

13. EXTERNAL IMPACT OR SENSITIVITY:	CHOICE	VALUE
NOT APPLICABLE		(1)
LOW LEVEL		(3)
MODERATE LEVEL		(5)
HIGH LEVEL		

14. INTERACTION ACROSS ORGANIZATIONS:	CHOICE	VALUE
EXCLUSIVE TO ONE OFFICE		(1)
WITHIN TWO FUNCTIONAL OFFICES		(3)
MORE THAN TWO FUNCTIONAL OFFICES		(4)
INVOLVEMENT WITH OUTSIDE ORGANIZATIONS		(5)

15. TYPE OF TRANSACTION DOCUMENT

CHOICE	VALUE
NON-CONVERTIBLE TO CASH OR BENEFIT	(1)
CONVERTIBLE TO SERVICES ONLY	(3)
DIRECTLY CONVERTIBLE TO CASH	(5)

16. INTERVAL SINCE MOST RECENT EVALUATION OR AUDIT:

CHOICE	VALUE
WITHIN LAST 9 MONTHS	(1)
BETWEEN 9 AND 24 MONTHS	(3)
MORE THAN 2 YEARS	(5)

17. RECENT INSTANCES OF ERRORS OR IRREGULARITIES:

CHOICE	VALUE
NONE IN THE LAST 18 MONTHS	(1)
MOST SIGNIFICANT FINDINGS OR KNOWN ERRORS FULLY CORRECTED	(3)
MOST SIGNIFICANT FINDINGS OR KNOWN ERRORS UNRESOLVED	(5)

18. ADEQUACY OF REPORTS:

CHOICE	VALUE
ACCURATE AND TIMELY	(1)
SOMETIMES INACCURATE, INCOMPLETE AND OR LATE	(3)
USUALLY INADEQUATE AND LATE	(5)

19. TIME CONSTRAINTS:

CHOICE	VALUE
NOT A SIGNIFICANT FACTOR IN OPERATIONS	(1)
OCCASIONALLY A FACTOR	(3)
A SIGNIFICANT DAILY FACTOR	(5)

PRELIMINARY ASSESSMENT OF SAFE GUARDS

20. ASSUMED EFFECTIVENESS OF EXISTING CONTROLS	CHOICE	VALUE
CONTROLS ADEQUATE		(1)
LESS THAN ADEQUATE		(3)
NO EXISTING CONTROLS OR COSTS OUTWEIGH BENEFITS		(5)

21. OVERALL VULNERABILITY ASSESSMENT:

LOW	<input type="checkbox"/> (LESS THAN 27)
MEDIUM	<input type="checkbox"/> (27-34)
HIGH	<input type="checkbox"/> (GREATER THAN 34)

22. MCR RECOMMENDED? ☐ YES ☐ NO

SCORE

↓

23. COMMENTS

24. VA CONDUCTED BY

Time

Date

25. VA APPROVED BY

Time

Date

FORMAT OF BASIC CERTIFICATION LETTER

From: Responsible Official (Component Head or Deputy)

To: (Next higher level in the chain of command)

Subj: MANAGEMENT CONTROL CERTIFICATION STATEMENT

Ref: (a) SECNAVINST 5200.35B

Encl: (1) Current Year Accomplishments/Material Weaknesses
Identified and Corrected
(2) Current Year Material Weaknesses and Corrective Actions
(3) Prior Year(s) Material Weaknesses - Status of Corrective
Actions
(4) Risk Assessment Report and Management Control Plan

1. The (title of component) has evaluated the system of internal administrative and accounting control in effect during the Fiscal Year ending 30 September 19___. The evaluation was performed per Department of the Navy policy contained in reference (a). Information to support the statement was derived from the management control program, audits, inspections, investigations, and other management reviews. Except for identified material weaknesses, the system of internal control in effect during the fiscal year provided reasonable assurance that the objectives of the Federal Managers' Financial Integrity Act were achieved.

2. Enclosure (1) provides 19___ management control program accomplishments and material weaknesses identified and corrected this fiscal year. Material weaknesses with ongoing corrective actions identified this fiscal year and the status of corrective actions for prior year(s) weaknesses are reported in enclosures (2) and (3), respectively. Enclosure (4) provides the risk assessment report and Management Control Plan for this fiscal year.

Signed
Component Head or Deputy

FORMAT FOR REPORTING ACCOMPLISHMENTS OR MATERIAL WEAKNESSES

1. Title of the accomplishment or weakness.

2. Source.

- Provide the source(s) used to identify this accomplishment or material weakness, e.g.,:

- Management Control Review
- DOD(IG) finding
- Naval Audit Service finding
- GAO finding
- Internal Review finding
- Service IG finding
- Other

3. Description.

- Provide a brief statement describing the accomplishment or material weakness.

4. Corrective actions:

MILESTONES

COMPLETION
DATES

- Provide corrective actions for material weaknesses in the form of milestones with an estimated completion date for each milestone.

APPENDIX D

MANAGEMENT CONTROL PROGRAM-- CRITERIA TO DETERMINE THE MATERIALITY OF WEAKNESSES

- (a) Actual or potential loss of resources
- (b) Sensitivity of the resources involved
- (c) Magnitude of funds, property, or other resources involved
- (d) Frequency of actual and/or potential loss
- (e) Current or probable media interest (adverse publicity)
- (f) Unreliable information causing unsound management decisions
- (g) Diminished credibility or reputation of management
- (h) Impaired fulfillment of essential mission
- (i) Violation of statutory or regulatory requirements
- (j) Impact on information security
- (k) Failure of the Government to provide the public with needed services
- (l) Apparent conflict of interest. [Ref. 22]

APPENDIX E

SELECTIONS FROM THE 1989 NAVY MANAGEMENT CONTROL CERTIFICATION STATEMENT

The following material weaknesses were selected from the 1989 Navy Management Control Certification Statement.

1. Reporting Category: Procurement
2. Title: Asset Capitalization Program
3. Source: GAO Audit NSIAD 89-147, Plant Modernization: DOD's Management of the Asset Capitalization Program Needs Improvement, August 1989
4. Description: The Asset Capitalization Program (ACP) does not have all the essential elements of a sound capital investment management program. The program lacked top management support and organizational responsibilities were unclear. It lacked a systematic approach to identifying investment opportunities, including long range activity modernization plans. Some activities had inadequate and inaccurate accounting records for depreciation expenses and plant property. Many project files did not contain complete information on the history of each project, date of receipt, installation and initial operation or were missing invoice documents because the activities either lacked specific or adequate guidance on what should be contained in the files.
5. Potential Consequences: Investment opportunities may be missed. Equipment items would not be depreciated and, in some cases, equipment would not be accounted for.
6. Related Appropriation(s): Navy Industrial Fund
7. Corrective Actions:

MILESTONES

STATUS

Direct commands to comply with existing guidance to ensure that capital investments are consistent with the

31 Mar 1990

activities' strategic plans and that projects are implemented in a timely manner.

Direct commands to comply with existing internal control procedures, develop procedures to verify that actual costs of equipment are recorded on depreciation and plant property records, and follow-up to ensure internal control procedures are being followed. 31 Mar 1990

Direct commands to assign sufficient personnel to manage and execute the program. 30 Jun 1990

1. Reporting Category: Supply Operations
2. Title: Receipt Confirmation
3. Source: GAO Audit NSIAD 88-179, Inventory Management, Receipt Confirmation problems, July 1988; and DoDIG Audit 89-114, Control Over Spares For New Weapon Systems, 22 Sep 1989
4. Description: Under the source acceptance method of expedited receipt, payments are made based on government inspection and acceptance of material at vendors' plants rather than upon receipt at government facilities. Navy systems did not have adequate controls to ensure that depots received material paid for on the basis of source acceptance. Additionally, controls over initial spares shipped from contractors to storage and user activities were inadequate. Internal control procedures had not been established to ensure that activities received initial spares and recorded the receipts in a timely manner.
5. Potential Consequence: Receipt confirmation and timely recording of receipts are the only basis for assuring that the government either receives what it paid for or recovers payments for items not received.
6. Related Appropriation(s): O&MN; WPN; APN; SCN; and OPN
7. Corrective Actions:

MILESTONES

STATUS

Establish interim procedures to ensure follow-up and recognition of in-transit source accepted shipments.

Completed

Implement revised Navy systems containing automated procedures to accomplish the necessary reconciliation and follow-up of in-transit source accepted shipments.

30 Sep 1991

Establish and Implement controls to require storage and user activities to acknowledge and record initial spares receipts within 60 days of date of shipment.

30 Dec 1990

Establish a system to follow-up on initial spares shipments that

30 Dec 1990

storage and user activities have not
acknowledged as being received.

1. Reporting Category: Personnel and/or Organization Management
2. Title: Reinvestigating Top Secret Clearances
3. Source: Command Inspections, Staff Oversight Reviews and Management Analyses
4. Description: Prior to July 1989, the Navy did not have a central file identifying military and civilian personnel with Top Secret security clearances. With the centralization of clearance determinations performed by the Department of the Navy Central Adjudication Facility (CAF), a personnel security clearance data base now exists. However, due to resource constraints and higher priorities, a program has not yet been established which will identify those individuals whose background investigations require updating, systematically notify commands to initiate reinvestigations, and monitor command control for ensuring initiation of reinvestigations.
5. Potential Consequences: One command identified almost 3700 personnel holding Top Secret clearances without having been subjected to a periodic reinvestigation within the past five years. This condition could result in the failure to identify, in a timely fashion, cleared personnel who may no longer be eligible for clearance due to disqualifying activities.
6. Related Appropriation(s): O&MN
7. Corrective Actions:

MILESTONES

STATUS

Establish a centralized data base of personnel holding Top Secret clearances.	Completed
Identify all personnel holding Top Secret clearances without reinvestigations.	1 Jan 1990
Identify all personnel having Top Secret clearances whose background investigations or secret background investigations were accomplished prior to 1984.	1 Jun 1990
Establish procedures to notify commands to request Defense Investigative Service to conduct Periodic Reinvestigations (PRs).	1 Jul 1990

Establish procedures to ensure reinvesti-
gations are conducted as required.

1 Dec 1990

1. Reporting Category: Supply Operations (OSD 88-15)
2. Title of Weakness: Cataloging of supply items
3. Source: Department of Defense Inspector General Audit Report 88-053
4. Description: The system of internal controls was not adequate to ensure that supply items were sufficiently or accurately cataloged within the Federal Catalog System. Items were insufficiently described, inaccurately cataloged, prematurely cataloged, and unnecessarily assigned a national stock number.
5. Potential Consequence: Improper cataloging of supply items increases the risk of undetectable duplication of national stock numbers in the supply system, is a poor use of resources, and degrades the quality of data by which users determine if items meet their requirements.
6. Corrective Actions:

MILESTONES

STATUS

Establish internal controls to ensure that available manufacturers' data are obtained/used during the cataloging process to facilitate the appropriate identification of items.	30 Jun 1989 Completed
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Establish internal controls to ensure that the identification of previously cataloged completed items are upgraded when the requisite additional data becomes available.	30 Jun 1989
--	-------------

Implement internal controls to ensure that a quality assurance program, as specified by DOD Manual 4130.2-M, is employed.	30 Jun 1989 Completed
---	--------------------------

Implement internal controls to assign item management codes in accordance with the criteria included in DOD Directive 4140.26, "Integrated Material Management of Consumable Items."	30 Jun 1989 Completed
--	--------------------------

1. Reporting Category: Property Management (OSD 88-24)
2. Title of Weakness: Inadequate procedures for control, storage and disposal of hazardous waste
3. Source: GAO Survey Code 392337, Naval Inspector General finding; Management Control Reviews
4. Description: Proper storage facilities are not always adequate or don't exist; procedures for control and disposal are sometimes inadequate; hazardous wastes are not properly stored and secured at confirming sites while awaiting usage or disposal; hazardous waste is not always properly labeled; lack of checklist to conduct annual reviews of hazardous waste and material; and lack of procedures for control and disposal of hazardous waste.
5. Potential Consequence: Inadequate storage of incompatible chemicals could result in a fire/explosion and inadequate disposal of hazardous waste could be a cause for air/water pollutants.
6. Corrective Actions:

MILESTONES

STATUS

Update hazardous material inventories to list correct method of storage and disposal. Completed

Review hazardous chemicals inventories; turn in for disposal all chemicals that are not required for current needs. Completed

Prepare standard checklist to be used to conduct annual reviews of hazardous waste and material and require all commands and activities to conduct annual reviews. 15 Dec 1989 Completed

- A Navy standard checklist has been completed. The requirement for activities to conduct annual reviews has been included in the Environmental Compliance Evaluation System. OPNAVNOTE 5090, of 20 June 1989, provides a means to monitor, achieve and maintain compliance with environmental regulations. Supplemental checklists covering many of the states are now available, the remaining (5) state checklists will be developed under contract by December 1990 assuming that FY-90 funds are available by November 1989. Based on

the correct actions taken to date, this milestone
is considered substantially complete

Revise procedures for control and disposal	1 Aug 1989
of hazardous material and classify program	Completed
responsibilities	20 Jun 1989

1. Reporting Category: Property Management (OSD 88-25)
2. Title of Weakness: Lack of effective Missing, Lost, Stolen, Recovered Property (M-L-S-R) reporting program
3. Source: Management Control Reviews, Inspection.
4. Description: Procedures for processing missing and damaged property are, in some instances, improper; there is a lack of loss prevention programs; and there is no command emphasis and oversight in the area of accountability.
5. Potential Consequences: Failure to comply with reporting requirements may result in degradation of the security program, continued and increased losses of Government property, inability to develop trends and analyses, and reduced capability to recover missing property.
6. MILESTONES STATUS

Revise M-L-S-R guidance and assign Program Manager to monitor M-L-S-R Reporting Program.	15 Nov 1988 Completed 18 Oct 1988
Propose that M-L-S-R Reporting Program be reinstated as a special interest item on command inspections.	1 Jan 1989 Completed 14 Dec 1988

Note: Reported complete in 31 March 1989 Status Report.

1. Reporting Category: Support Services (OSD 88-45)
2. Title of Weakness: Inadequate audit standards, performance, training, and reporting
3. Source: Naval Audit Service Reports C37116, 013-C-88, 006-N-88, 023-C-88; General Accounting Office Review of the Effectiveness of the Naval Audit Service; Department of Defense Inspector General quality assurance reviews
4. Description: The effectiveness of the Naval Audit Service non-appropriated fund, and exchange audit components has been hampered by the lack of properly qualified and trained audit personnel; inadequate supervision in the planning, performing and reporting of audits; lack of audit evidence documentation and standardization of audit reports; improper use of audit personnel to perform nonaudit tasks; and instances of compromise of audit independence.
5. Potential Consequence: Inadequately qualified and trained personnel are unable to perform quality audits thereby diminishing the effectiveness of the entire audit program. Due to lack of adequate supervision, audits are not planned, conducted, and reports written in accordance with Comptroller General's standards for examination and evaluation. Frequent turnover in audit personnel is experienced. Lack of audit independence jeopardizes the integrity of the audit program.

6. Corrective Actions:

MILESTONES

STATUS

Establish Naval Audit Service (NAVAUDSVC), Commandant of the Marine Corps (CMC), Navy Resale and Services Support Office (NAVRESSO), and Chief of Naval Operations (CNO) documentation procedures to ensure audit report content and format requirements are met. Completed

NAVAUDSVC alter the composition of the annual audit plan to provide greater potential for management improvement, readiness improvement, and monetary savings. Completed

NAVAUDSVC document the supervisory process for producing audits and properly oversee administrative functions to produce quality audits. Completed

Assign command control to maximize NAVAUDSVC, CMC, NAVRESSO audit group's independence.	Completed
Train CMC, NAVRESSO, CNO audit staff on workpaper preparation and filing standards and establish procedures to control and safeguard workpapers.	Completed
Institute procedures at NAVRESSO for the positive verification of prospective employees' educational qualifications	Completed
Prohibit use of NAVRESSO audit personnel for non-auditing tasks.	Completed
Establish and submit new staffing standards and assign CMC staff accordingly.	Completed
Develop written procedures to guide CMC, NAVRESSO, CNO auditors in recognizing potential instances of fraud, waste, and illegal acts, extending audit steps, and notifying DOD investigative agencies.	1 Dec 1988 Completed 22 Dec 1988
Develop and implement a formal training program for both auditors and supervisors at NAVAUDSVC, CMC, NAVRESSO.	30 Sep 1990 On target

1. Reporting Category: Support Services (OSD #87-49)
2. Title of Weakness: Management of certain aspects of health care operations
3. Source: NAVAUDSVC Report T38086 and Command Inspection Report
4. Description: Effective management oversight was lacking in certain Navy health care operations thereby hampering development and implementation of a comprehensive health care management plan. Appropriate analytical techniques and information resources were either not used or were unavailable to monitor and improve the delivery of health care. A centralized automated information system did not exist to collect and analyze malpractice data, impairing the Navy's ability to assure quality care and reduce the risk of financial loss from claims. Support for the increasing use of medical services contracts was inadequate. Procedures related to replacing, maintaining and controlling medical and dental investment equipment were inadequate or were not being followed. Also, the medical/dental manpower planning function was found to be fragmented and ineffective. Medical unit requirements were not being developed against wartime missions resulting in potential wartime shortages in critical medical subspecialties. Appropriate policy direction, oversight and resource advocacy for Operational Medicine (OM) was lacking. Shortfalls in OM capabilities adversely impact the warfighting capability of the Navy and Marine Corps.
5. Corrective Actions:

MILESTONES

STATUS

Develop a system to track medical personnel status and requirements relative to both peacetime and wartime billets and deployments.	Completed
Increase the visibility and support of OM to enhance its capability and heighten the level and quality of medical support to the operating forces.	Completed
Ensure manpower authorizations reflect a reserve requirement when a wartime billet cannot be filled from active duty end-strength.	1 Dec 1989 Revised to 1 Oct 1990

- The entire shore organization of Navy medicine is being reorganized. Some organizations will be realigned, some will be disestablished and others will be provided different missions. When manpower authorizations are finalized, the active/reserve configurations will be ensured.

Evaluate and reemphasize procedures for management and control of health care equipment.	Completed
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Analyze the difference between peacetime and wartime manpower requirements and develop a plan to bridge the gap.	1 Dec 1989 On target
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Establish procedures and develop a management information system to ensure appropriate health care quality indicators are reviewed, analyzed and acted upon.	30 Dec 1990 Revised to 1 May 1990
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- Guidance issued prescribing format and content of the Management Information Report (MIR). MIR submissions due 1 February 1990 will be reviewed for thoroughness, utility, and documentation of appropriate action by oversight activities during review and endorsement. Assessment of MIRs utility expected by 1 May 1990.

Develop a manpower planning system which requires the use of staffing standards, identifies shortfalls, prioritizes current and future workload and integrates reserve and active forces.	1 Dec 1989 Revised to 1 Oct 1990
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- The ASD(HA) health care standards are being used in the present Navy Manpower Management Operating System. However, a manpower planning system meeting the milestone requirements will not be in place until the Navy's reorganization of the medical department is completed.

Establish a centralized automated system to collect and analyze malpractice data.	1 Oct 1990 On Target
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1. Reporting Category: Property Management (OSD #86-25)
2. Title of Weakness: Inaccurate control and accountability over tool inventories
3. Source: Audits and Management Control Reviews
4. Description: Controls and accountability over tool inventories are inadequate. Adequate policies, procedures and accountability for tools are not established. Comprehensive physical inventories are not conducted periodically. Controls are inadequate or have not been implemented for reporting lost, damaged or stolen tools. Reports on missing, lost, stolen or recovered tools and inventory discrepancies were not made and investigated. Automated tool control systems do not provide for complete accountability and control of millions of dollars of tools. Centralized accountability, control and receipt over all tools is not established at all activities. Employee accountability for lost tools is not enforced. Follow-up procedures are not in effect to ensure that tools are returned within established issue periods.

5. Corrective Actions:

MILESTONES

STATUS

CNO designate a command to serve as the Navy focal point for tool control accountability.

Completed

Determine adequacy of controls necessary to maintain accountability over tool inventories and evaluate cost/benefits.

Completed

CNO develop and issue a comprehensive instruction covering policy, procedures and accountability for tools.

1 Jun 1989
Completed
10 Mar 1989

Note: Reported complete in 31 March 1989 Status Report.

1. Reporting Category: Comptroller/Resource Management (OSD #85-50)
2. Title of Weakness: Travel advances
3. Source: Audit and Management Control Reviews
4. Description: Weaknesses in the control of travel and travel advances were pervasive throughout the DON. Insufficient controls existed to ensure that Permanent Change of Station (PCS) and Temporary Duty for Instruction (TEMDUINS) travel advances are liquidated in a timely manner. Procedures for follow-up and settlement of outstanding travel advances and management of travel funds were found to be inadequate.
5. Corrective Actions:

MILESTONES

STATUS

CNO develop a plan of action and milestones to address travel/travel advance related deficiencies from a Navy-wide perspective and complete appropriate corrective actions.	30 Sep 1988 Completed
CMC apply review emphasis in the areas of follow-up and settlement of travel advances to obtain substantial correction of weaknesses Marine Corps-wide.	30 Sept 1991 On Target
Incorporate improved travel control and monitoring capabilities in the Standard Accounting, Budgeting and Reporting System (SABRS).	30 Nov 1988 Completed
Provide improved temporary additional duty computation, management reporting and check production capabilities through the Marine Corps Travel Advance and Settlement System (MCTASS).	30 Sep 1991 On Target

Source: [Ref. 34]

APPENDIX F

ADDITIONAL READING LIST

- GAO Government Auditing Standards
- GAO Standards for Internal Controls in the Federal Government, 1983
- GAO/APMD 88-10. Financial Integrity Act. Continuing Efforts Needed To Improve Internal Controls and Accounting Systems
- OMB Circular A-123, revised 16 August 1983
- DODD 7040.6, Internal Control Systems, 24 March 1982
- DODD 7600.2, Audit Policies, 10 January 1985
- DODD 7600.7-M, Internal Audit Manual, June 1986
- DODD 7650.3, Followup on General Accounting Office, DOD Inspector General, Internal Audit, and Internal Review Reports, 5 September 1989
- SECNAVINST 5200.35B, DON Management Control Program, 25 March 1988
- SECNAVINST 7510.7D, DON Internal Audit, 9 May 1989
- SECNAVINST 7510.9, Command Management Economy, Efficiency and Review, 13 April 1989

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3. Limited Effectiveness of Naval Audit Service, General Accounting Office Report, GAO/APMD 88-12.
4. Practical Comptrollership, The Bottom Line, Naval Postgraduate School, Monterey, California, October 1989.
5. Arens, Alvin A., and James K. Loebecke, Auditing, An Integrative Approach, 4th Ed., Prentice Hall, Inc., 1988.
6. United States General Accounting Office, Accounting Series, Standards for Internal Controls in the Federal Government, 1983.
7. DODD 7040.6, 24 March 1982.
8. Financial Integrity Act. Continuing Efforts Needed to Improve Internal Controls and Accounting Systems, General Accounting Office Report, GAO/APMD 88-10.
9. OMB Circular A-123, revised, 16 August 1983.
10. SECNAVINST 5740.26, 24 March 1986.
11. DODD 7600.2, 10 January 1985.
12. DODD 5106.1, 14 March 1983.
13. Interview between David House, Director, Inspections and Planning, Department of Defense Inspector General and author, 3 April 1990.
14. SECNAVINST 5430.57E, 6 August 1987.
15. DODD 5105.36, 8 June 1978.

16. Naval Audit Service Lecture, Practical Comptrollership Course, attended by author, Naval Postgraduate School, Monterey, California, 5 February 1990.
17. SECNAVINST 7510.7D, 9 May 1989.
18. Interview between Brian MacAndrew, Director, Audit Policy, Naval Audit Service, and author, 5 April 1990.
19. Interview between Marilyn Young, Special Agent, Representational Resident Agent, Naval Investigative Service, Monterey, California, and author, 13 April 1990.
20. SECNAVINST 7510.9, 13 April 1989.
21. OPNAVINST 5000.52, 22 December 1989.
22. SECNAVINST 5200.35B, 25 March 1988.
23. Department of Navy Management Control Program Training Course attended by author, Naval Postgraduate School, Monterey, California, 3 January 1990.
24. OPNAVINST 5200.25B, 12 June 1988.
25. U.S. Department of the Navy, Office of the Comptroller, Navy Comptroller Manual, NAVSOP-1000, Volume 4, November 1984.
26. Interview between Jerry Fitzgerald, Director Morale, Welfare and Recreation Auditing, Naval Military Personnel Command, and author, 16 February 1990.
27. DODD 7600.7-M, June 1986.
28. Interview between Bruce Causseaux, Naval Audit Service, Capitol Region, Washington, D.C. and author, 5 February 1990.
29. Interview between Sheilah Morris, Command Evaluation Department, Naval Postgraduate School, Monterey, California and author, 7 February 1990.
30. DODD 7650.3, 5 September 1989.
31. Interview between David T. Waggoner, Captain, USN, Commanding Officer, Naval Air Station, Whidbey Island, and author, 27 February 1990.
32. NAVSUP Notice 5040, 10 April 1989.

33. Department of the Navy Internal Audit Plan for Fiscal Year 1990, 15 September 1989.
34. Memorandum for the Secretary of Defense from Department of the Navy, Office of the Secretary, 24 November 1989.
Subject: Management Control Certification Statement.

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